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ABSTRACT

One of a series of three self-instructional units, these materials are aimed at helping British hotel and catering managers improve profits and/or reduce costs in their areas of responsibility. Following an introduction and a paragraph on how to use the unit, section 1 covers how to use management information. The section includes these trainee objectives and pencil and paper activities to help trainees meet them: (1) specify, for a given management position, what financial reports should be produced and how frequently; and (2) describe how point-of-sales equipment and computer-based information systems can assist in the production of management information and specify the general requirements for such systems. Section 2 tells how to interpret financial reports and includes pencil and paper activities to help trainees meet these objectives: (1) identify how different receipts and expenditures affect profit measurement; and (2) interpret financial reports by analyzing variances and trends. Section 3 teaches how to use budgets for planning and control and includes pencil and paper activities to help trainees meet these objectives: (1) understand how revenue budgets should be prepared; (2) prepare a simple profit forecast for an operating department, using given historical data and specified assumptions; (3) prepare a simple revenue budget for an operating department, using a given profit forecast and given quantified actions for profit improvement; and (4) understand how revenue budgets are used to control business performance. (CML)

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INCREASING OPPORTUNITIES
for
SUPERVISORS AND MANAGERS

INTERPRETING FINANCIAL RESULTS

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OPERATIONAL MANAGEMENT PROGRAMME

Financial Management
MODULE

INTERPRETING
FINANCIAL RESULTS

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INTERPRETING FINANCIAL RESULTS

	PAGE
HOW TO USE THIS UNIT	2
INTRODUCTION	2
SECTION 1 Using management information	3
SECTION 2 Interpreting financial reports	17
SECTION 3 Using budgets for planning and control	31

HOW TO USE THIS UNIT

The material in *Interpreting Financial Results* is presented in a self-study format. Most pages require you to make a response to the information presented, or to consider what you might do on the basis of your experience and knowledge. Space is provided below these activities for you to write your answers. Possible responses or appropriate guidance is given on the following page.

INTRODUCTION

The overall aim of the three financial management self-study units and the one-day HCTC courses is to enable hotel and catering managers to improve profits (and/or reduce costs) in their area of responsibility. This unit is divided into three sections covering:

- using management information
- interpreting financial reports
- using budgets for planning and control.

Controlling Costs deals with the principles of cost control, the role of sales forecasting in effective cost control, how to forecast, measure and control material costs, calculating potential sales values, estimating and controlling employment costs, staff productivity and cash flow management.

Making Financial Decisions covers the role of departmental/unit managers in pricing, investment and budget preparation, pricing decisions and techniques, and assessing investment opportunities.

Delegates on HCTC courses receive a number of assignments.

SECTION 1
Using management information

After completing this section you will be able to:

- specify, for a given management position, what financial reports should be produced and how frequently
- describe how point of sales equipment and computer based information systems can assist in the production of management information and specify the general requirements for such systems.

Information is needed by organisations for planning and controlling the business.

MANAGEMENT INFORMATION SYSTEMS

Most organisations produce regular reports to draw the attention of managers to important financial facts and figures which affect the company. The way in which this information is put across is called a management information system. Systems vary from organisation to organisation.

Management information systems consist of some or all of the following:

Routine reports These are standard reports produced on a regular basis which on the whole produce few surprises. One of their chief functions is to ensure that company objectives continue to be met. However experience has proved that if companies produce too much routine data of this nature the result is often ineffective control.

Exception reports One way of overcoming the problem of burdening managers with too much routine data is to design reports which highlight only the information that deviates from the company's plans during the control phase. Reporting by exception is based on the idea that if the control system is working as it should then no management intervention is required and so no report need be produced.

Ad-hoc reports These are one-off reports which will probably not be required again. For instance a restaurant manager might want a report on the previous year's wedding receptions, relating the consumption of champagne to the number of guests catered for.

For management information systems to be truly effective in planning and control they must consist of more than the formal reports prepared by company accountants. Although these reports are essential and will tell you, for instance, when something is wrong, they seldom give an indication of why something has gone wrong or how to correct it. That is the manager's job. Personal observation and questioning play a vital and complementary role to a formal management information system. Managers often keep their own facts book which is a constantly updated record of information not necessarily available from the accountants' formal reports.

Information is useful only if it can be acted upon and so it must be:

- given at appropriate times
- presented clearly.

Imagine you are the manager of one of the catering outlets in a large university. You already receive a four-weekly profit and loss statement. List below the other financial reports which you would like to receive daily, weekly and four-weekly.

INTERPRETING FINANCIAL RESULTS

A departmental manager would probably find the following financial reports essential:

Daily	analysis of products sold by shift
	details of the hours worked by each employee
	summary of requisitions from stores
Weekly	total sales
	total food and beverage expenses
	total employment expenses
Four-weekly	other operating expenses

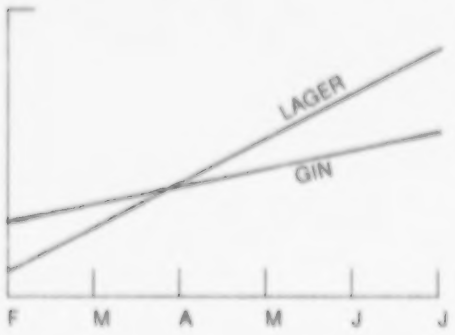
Collecting and distributing information is expensive, and many organisations produce reports more frequently than is necessary. It is pointless, for example, to report equipment rental on a monthly basis if the minimum time required to renegotiate the rental contract is six months. Appropriate intervals for reporting may also be decided because they provide a useful and convenient comparison with each other. For instance complete profit and loss statements are usually prepared every four weeks, rather than every calendar month, because this gives 13 comparable accounting periods each year, plus a day (or two days in a leap year).

From the figures on sales of gin and lager shown below, work out which is growing at a faster rate.

Month	Bottles of gin	Kegs of lager
February	54	9.7
March	58	12.4
April	67	15.8
May	75	17.3
June	82	20.6
July	85	24.7

How could you present the data to show the trend in sales more clearly?

The sales of lager are growing at a faster rate than the sales of gin. A good way of making sense of this data, in other words converting it into easily understood information, is to present it as a graph showing sales against time.



Badly presented data can be confusing rather than informative. Managers are busy people who should not have to waste time trying to decipher reports. If data is misinterpreted or missed altogether the consequences to planning and control might be disastrous. Important information should therefore be specifically highlighted, for instance by graphs and diagrams, so that it is easily recognisable and absorbed.

Information systems should not be fixed. Instead they should be capable of being developed and changed in response to the demands of the business. For instance, each of the following developments might alter the kind of data collected and the way it is handled:

- statutory changes in VAT recording procedures or accounting practice
- development of new services within the organisation
- enlargement of the premises.

Reports often contain what are called *direct measurements of variables*, or *direct variables*, for instance:

- we sold 210 evening meals last week
- 13 bottles of champagne were consumed at the reception.

Direct variables are sometimes combined to produce what are called *derived variables* or *measures*, for example:

- 45 miles per gallon
- the ratio of evening meals supplied to guests staying in the hotel, say 3:1
- the number of wedding guests per bottle of champagne, say six guests to every one bottle
- one waiting staff to every five tables.

Derived measures can be used as a point of reference or norm, and they are often expressed as ratios of performance to compare present with past achievements. The retail price index, for example, is a means of comparing general prices with those of a previous date, say 1975, which would be expressed as 100 points. Thus a retail price index of 200 means that prices are exactly twice what they were in 1975 (2 x 100 = 200). Similarly it may be useful to know that 1851 evening meals were sold to 617 hotel guests, but if this result is expressed as a ratio of 3:1, then it can be used to judge performance by comparing it with earlier months, the same month of the previous year, and so on.

A different kind of measure, for instance a derived measure rather than a direct measure, can lead to a completely different conclusion. So if the right decisions are going to be made or the most appropriate action taken, it is important to make sure that the original data collected is relevant.

The value of the stock in the bar of the Crown Hotel in September was £12,000. The hotel manager interpreted this as overstocking since the stock level in March was only £6000. Was the hotel manager necessarily correct? Explain below how derived measures could be used to clarify the situation more fully?

The hotel manager is not necessarily right in believing that overstocking took place. Say monthly turnover increased from March to September:

Month	Stock	Turnover	Ratio of stock to turnover
March	6,000	12,000	1:2
September	12,000	36,000	1:3

The derived results show that the ratio of stock to turnover improved in September compared to March, which can be interpreted as improved performance and not overstocking.

REVENUE REPORTS

Daily and weekly revenue reports give the analysis and comparison necessary for:

- forecasting production and staffing
- directing sales effort, particularly personal selling
- measuring the effectiveness of marketing decisions such as sales promotion or price reviews
- cost control, in particular the calculation of potential cost percentages.

Normally the revenue report clearly identifies the number of sales and average spend, broken down into as many separate market segments as are necessary for forecasting and evaluating selling effectiveness.

Crown Hotel

DAILY REVENUE REPORT **Date**

	FOOD			BEVERAGES		TOTAL REVENUE
	Number of covers	Average spend £	Total revenue £	Average spend £	Total revenue £	£
MILTON RESTAURANT						
Breakfast						
Lunch						
— hotel guests						
— special parties						
— chance						
— total						
Dinner						
— hotel guests						
— special parties						
— chance						
— total						
TOTAL						
BOWLERS COFFEE SHOP						
— morning shift						
— evening shift						
TOTAL						
BANQUETING						
— River Room						
— Meadow Room						
TOTAL						
TOTAL FOOD & BEVERAGES						

BEDROOMS	Number	Revenue £		Number
Beds sold			Rooms unsold	
— full rate			— vacant	
— business rate			— out of service	
— group rate			— complimentary	
— weekend rate			— staff use	
— total			— total	
Rooms sold				
— twins/doubles				Percentage
— singles				
— suites			Double occupancy	
— total			Bed occupancy	
			Room occupancy	
TOTAL BEDROOM REVENUE	—			
				Average revenue £
TOTAL HOTEL REVENUE	—			
			Per bed sold	
			Per room sold	

POINT OF SALE INFORMATION SYSTEMS

The amount and type of revenue control information available in a hotel or catering business depends on the choice of point of sale systems.

Cash registers

The most simple point of sale equipment is a mechanical cash register which adds up figures and has a visual display. It will also print out various documents:

Customer receipt Lists the prices of the items purchased, the total amount due, and the date of purchase.

Audit roll Gives a duplicate of each transaction for control purposes.

Cashier's report Shows the cumulative total of cash received and the number of transactions.

Electronic cash registers offer more sophisticated analysis. A common feature is an *item look up* which stores the name and price of the items sold. Instead of entering £0.95 the cashier pushes a button marked 'whisky' and the register automatically records 'whisky £0.95'. An electronic register may also have:

Customer receipt Records the name and price of each item purchased, the cash received and the change given.

Check Names the item purchased to authorise issue from the kitchen.

Sales mix report Shows the numbers of each item purchased, possibly according to the time of day.

Cashier's report Shows the value of sales by different members of staff and total sales for each method of payment (cash, credit card, account, and so on).

Integrated microcomputer systems

Microcomputer-based point of sale equipment can be used to control all aspects of a catering operation.

A system for a fast food restaurant, for instance, may comprise eight keyboards, four VDUs, eight cash drawers, four printers for customer receipts, and a remote screen and printer for management control. It may store standard recipes, predict ingredients required, hold data on stock movements, act as a time clock for staff, and calculate wages. Additional data may also be available on:

- hourly sales per employee
- wages costs
- gross profit rates
- wastage
- stock losses.

Network computer systems

Point of sales equipment may be linked into a central system. For instance the equipment in a hotel restaurant may be part of a network linked to the central hotel cashier's office. This enables restaurant sales to be charged directly to guests' hotel accounts, or the general manager to get up-to-the-minute reports on the financial performance of the whole hotel. This type of network can also be used for a number of businesses in different locations all linked to a central office.

GETTING THE RIGHT SYSTEM

Many companies choose an off-the-shelf package which can be adapted to suit their needs. When deciding on a system managers should be able to explain to the equipment supplier, and anyone else who needs to know, what the system will be required to do. In this way the most suitable system for the company's control purposes can be selected. The best way to do this is to think in terms of results — knowing the production cost of a certain dish, rather than processes — how a menu is costed.

Imagine that you are the manager of the large university catering operation and considering installing a computer-based planning and control system. List below, in general terms, the requirements of a suitable system.

Requirements will vary from company to company, but they are likely to include:

Ease and speed of operation Particularly important for handling customer transactions, recording stock usage and similar activities where delays can increase costs or cause customer dissatisfaction.

Security of the system Can restrictions be imposed on who operates terminals, updates records or accesses information, for example by a system of passwords or security keys? The equipment may also need to be physically robust if it is used in areas such as bars or stores.

Networking Can the system link up a number of terminals in different locations, for example at head office?

Cash control Will the system produce bills, analysis of payment methods and cashier's reports?

Sales analysis Will the system provide the appropriate details, meeting requirements on frequency and accuracy?

Labour costs and productivity Will the system keep employee records and compile payrolls, possibly using time cards for entering data and analysing sales per person hour?

Stock control Will the system keep records on stock held, provide reports on low or slow moving stocks, record goods received, allocate costs to appropriate departments and make comparison of food and beverage costs?

Management reporting Can the system produce management reports, possibly variance analysis, regularly or on demand?

SECTION 2
Interpreting financial reports

After completing this section you will be able to:

- identify how different receipts and expenditures affect profit measurement
- interpret financial reports by analysing variances and trends.

MEASURING PROFIT

Profit is measured for a defined period of time, say one year or one week. It is not always easy to decide whether a particular item of revenue or expense should be included in one period or another. While such decisions are clearly the concern of accountants, managers need to appreciate how expenses and revenue are measured so that they can make correct interpretations of financial statements. When an item of revenue or expense is included in the profit calculations in a particular period, accountants say the item has been *recognised*.

Imagine a hotel which concludes an agreement with a tour operator for the sale of bedroom accommodation. The contract is signed in February and the tour arrives in June. When should the hotel recognise the revenue? Your intuition has probably told you, quite rightly, that the revenue is recognised in June when the service is provided.

Say the tour operator does not pay the account until September. When should the revenue be recognised now? Accounting practice requires that the revenue is still recognised at the time when the service is provided — in June.

Even if the tour operator has paid for the accommodation in advance, in March, the revenue would still not be recognised until June.

So revenue is recognised when the product or service is provided, which can be:

- before the cash is received
- after the cash is received
- at the same time as the cash is received.

MEASURING EXPENSES

Items of value are known as *assets*. For example a restaurant may buy some chairs, tins of peas, and cleaning materials. These are all assets of the business. A decrease in value of an asset is known as an *expense* of the business.

Suppose the cleaning materials were bought in March one year but by March the following year none of them had been used. Should the materials be recognised as an expense during that year? The answer is no, because this asset had not decreased in value during the year and so no expense was incurred. The purchase of an asset is called an *expenditure*.

Say the peas were bought for £100 in March one year and by the following March only half of them were left. Should the peas be recognised as an expense during that year? Some of the asset had been used, and so an expense of £50 should be recognised that year.

Imagine the chairs were used in the restaurant throughout the year and were still in good condition at the end of that time. Items like chairs which have a life of several years are known as *fixed assets*. Accountants estimate the total life of a fixed asset and charge a proportionate expense during each year. This is called *depreciation*. Say the chairs have been bought for £1200 and have been estimated to have a useful life of eight years. There are several ways of calculating depreciation, but to recognise an expense of £150 for that year would be straightforward and logical (£1200 ÷ 8 = £150).

So far only expenditures which are made before the relevant expense is recognised have been looked at. It is also possible for expenditures to be made after the expense is recognised. For instance the restaurant's telephone bill for the period 1 January to 31 March may not be paid until May — but the charges should still be recognised as an expense in the period when the telephone was used. Accountants use an estimated value in calculating telephone expenses for the complete financial year, say from 1 April to 31 March. This estimated amount is called an *accrued expense*.

Imagine that you are the manager of a small hotel examining your profit and loss statement for a particular year: 1 January to 31 December. You know that these transactions occurred:

- *A microwave oven was purchased for £500 cash.*
- *The rent is paid once a year on 1 March.*
- *A residential conference was held in the hotel from 12 to 16 December but the account of £1500 has not yet been paid.*
- *A deposit of £50 has been received for a wedding reception which is due to take place the following June.*
- *12 cases of champagne were purchased for £1200 on 1 December. On 31 December only three cases remain. The supplier's account has not been paid.*

Note below (in general terms) how you would expect these transactions to feature in the profit and loss statement.

Microwave oven

Rent

Conference

Deposit

Champagne

The transactions should feature in the profit and loss statement as:

Microwave oven

An amount for depreciation would appear as an expense.

Rent

An accrued expense for the year 1 January to 31 December would appear.

Conference

All the revenue would be recognised.

Deposit

The deposit would not be recognised in the profit and loss statement.

Champagne

An expense of £900 (for nine cases) would be recognised.

MEASURING ASSETS AND LIABILITIES

Assets are items of value owned by the business. Fixed assets have a relatively long life and are not for resale or conversion into cash. In a hotel or restaurant, furniture, kitchen equipment and freehold premises are all examples of fixed assets.

Assets which are held for resale or conversion into cash are known as *current assets*. Examples of current assets are stocks of food and drink. The distinction between fixed and current assets is an important one when considering the financial health of a business, by providing the answer to the question 'Can this business find enough money to pay its bills?'

Current assets can quickly be converted into cash, whereas fixed assets are more difficult to sell without curtailing the business. Both cash itself and the cash which is due to the business from unpaid accounts (called *debtors*) are current assets.

Amounts which the business owes, for example in unpaid suppliers' accounts, or taxes are termed *liabilities*. Assets and liabilities are not included in the profit and loss statement, but are reported in a document called a *balance sheet* which gives a snapshot of the amounts owed and owned by the business. There are only three ways in which a business can acquire assets:

- by using capital contributed by the owners or shareholders
- by using profits earned by the business (and retained or kept in the business)
- by using money owed to suppliers or banks — the liabilities of the business.

At any one time the sum of the assets of the business is equal to the sum of the liabilities, plus the retained profit, plus the capital. These must by definition remain in balance.

OBJECTIVES

Objectives are statements of what is intended to be achieved. They are used to set targets and to monitor progress. Clear objectives help employees in large organisations to direct their efforts towards important goals. A business will have several objectives, at least one of which will be a financial objective.

It needs to set profit objectives which ensure that the expectations of financial backers are met, or the very existence of the business not threatened. For instance in limited companies, directors are appointed specifically to look after the shareholders' interests by ensuring that the share price increases and by maintaining adequate dividends. Failure to meet the expectations of the shareholders will lead to difficulty in acquiring future funds. Other financial backers such as banks may impose more immediate sanctions if their expectations are not met by calling in their loans and winding up the business. (In the non-profit making sector the financial objective will be to operate within subsidy limits.)

Setting objectives is complex and is usually undertaken by the board of directors. To give a useful indication of what needs to be done, objectives should be quantified so that progress towards the objective can be monitored. An example of a quantified financial objective is to produce pre-tax profits of £160,000 in year three of the business to enable the company to:

- pay a dividend of 11.8p on each ordinary share
- retain profits of £15,000.

Note below, in general terms, what action management can take to ensure that profit objectives are achieved.

The normal policy of the Crown Hotel is to increase room rates in line with inflation. The price review takes place at the beginning of the third quarter of every year. Changes in the sales mix cause some variation in average room rate from quarter to quarter:

	Quarters			
	1	2	3	4
1989	26.92	26.32	28.83	28.98
1990	28.99	28.45	29.88	

It is assumed that the general rate of inflation for 1991 will be 4%, and that there is no reason to expect the pattern of seasonal variation to change.

Write below your forecast for average room rates. (Remember to include a 4% increase in the third quarter of 1991.)

The most important management activity in achieving any objective, including a profit objective, is to ensure that a plan is prepared and that performance is controlled to keep it in line with the plan.

Planning is concerned with what needs to be done. Financial planning is deciding what needs to be done in order to achieve the profit objectives of the business. The primary tool of financial planning is called the *budget*. A budget is simply a statement of intention in financial terms. It shows for a certain period of time how a business intends to use its financial resources, and the revenues, expenses and profits which will result from it. Part of every budget will be a planned profit and loss statement usually broken down to give detailed revenue and expense targets for each week of the year.

Control is about ensuring that plans are successfully put into operation — monitoring progress to check that objectives are likely to be achieved. Control is effected by measuring actual performance, for example the weekly sales revenue, then comparing this with the planned performance (budgeted figure) and finally taking action which will correct any shortfall in performance. Suitable action in this instance might include improving selling techniques, changing prices or advertising. Some people mistakenly think that effective financial control is concerned with collecting pieces of paper which report how badly or how well the business is doing. It is definitely not. Effective financial control is concerned with taking the necessary action to ensure that profit objectives are achieved.

First calculate the percentage increase in average room rates of 1990 over 1989 for each quarter:

	Quarters			
	1	2	3	4
1989/90	+7.7%	+8.1%	+3.6%	

The price review in mid 1989 appears to have produced average rates which are about 8% higher than the previous year. The price review in mid 1990 has produced average rates which are 3.6% higher than the previous year. It is assumed that the price review in 1991 will produce average rates which are 4% higher than in the previous year. Based on this the forecast is:

	Quarters			
	1	2	3	4
1989	26.92	26.32	28.83	28.98
1990	28.99	28.45	29.88	*30.02*
1991	*30.03*	*29.47*	*31.07*	*31.22*

Average spend data change slowly over a period of time. A graph of average spend is an effective way of projecting trends. Remember that average spend is subject to seasonal variation and this needs to be taken into account in the forecast.

Once the forecasts of volume and average spend have been prepared, then total sales can be calculated directly, for example:

	Quarters			
Forecast 1991	**1**	**2**	**3**	**4**
Number of room nights	3025	3870	2345	2765
Average room rate	30.03	29.47	31.07	31.22
Net sales revenue	90,840	114,050	72,860	86,325

VARIANCES

Some departmental operating statements make the task of interpreting the figures much easier by calculating the variances for you. This is done by comparing the actual results with the budget, and highlighting the variances. These variances are usually annotated as B (Better) or W (Worse) than budget, for example:

	Actual	Budget	Variance
Food sales	9980	9600	380B
Allowances to customers	130	100	30W
Net food sales	9850	9500	350B
Cost of sales	3440	3150	290W
Food gross profit	6410	6350	60B

(Remember that a cost which is bigger than budget will be worse, whereas a revenue or profit which is bigger than budget will be better.)

Examine this extract from a departmental operating statement, calculate the variances and list them in order of priority — with the biggest problem first.

	Actual	*Budget*	*Variance*
Supplies	*450*	*400*	
Laundry	*260*	*250*	
Music and entertainment	*340*	*300*	
Linen and uniforms	*210*	*200*	
Cutlery, glass and utensils	*110*	*150*	

The next stage is to project the expenses of the business. Each type of business expense may call for separate treatment depending on the nature of the cost — fixed or variable —and the likely effect of inflation.

The rooms department manager at the Crown Hotel is preparing a forecast of employment costs for the housekeeping and front office departments.

	Quarters 1989				*Quarters 1990*		
	1	*2*	*3*	*4*	*1*	*2*	*3*
Number of room nights	*2937*	*3756*	*2276*	*2684*	*3130*	*3868*	*2347*
Housekeeping							
productive hours	*2881*	*3043*	*2750*	*2831*	*2919*	*3065*	*2764*
average hourly rate	*2.66*	*2.68*	*2.85*	*2.83*	*2.83*	*2.85*	*3.01*
Front office							
productive hours	*2569*	*2610*	*2533*	*2580*	*2603*	*2600*	*2588*
average hourly rate	*3.26*	*3.28*	*3.42*	*3.36*	*3.46*	*3.48*	*3.61*

The average hourly rate varies from season to season because of holidays and absenteeism. All staff receive an annual wage increase at the beginning of the third quarter, and the hotel manager has suggested that this should be 7% in 1991.

Write below your forecast of the hours and rate for the last quarter of 1990 and all of 1991. (Remember that some jobs result in employment costs which are largely fixed. Others may give rise to semi-fixed costs.)

	Year/quarter				
Forecast	***90/4***	***91/1***	***91/2***	***91/3***	***91/4***
Number of room nights	*2765*	*3025*	*3870*	*2345*	*2765*
Housekeeping					
productive hours					
average hourly rate					
Front office					
productive hours					
average hourly rate					

Supplies	50W
Music and entertainment	40W
Laundry	10W
Linen and uniforms	10W
Cutlery, glass and utensils	40B

Financial control is concerned with taking corrective action. Often when you are confronted with a departmental operating statement for the first time it is difficult to see exactly what the priorities are.

The best starting point is to examine the monetary variances for the current period, and draw up a list of the variances in order of their adverse effect on profit. The biggest 'worse' variance is the major priority and needs to be acted upon first.

If your departmental operating statement does not include variances then it is a good idea to calculate these yourself and write them on the statement itself. This helps you analyse the problem areas.

So far only expense variances have been examined and arranged in order of priority. It is rather more difficult to interpret sales variances, cost of sales variances and gross profit variances. Managers need to be able to interpret a departmental operating statement to assess whether it is necessary to take action to promote sales or to control the cost of sales.

Which of these two variances has the greater adverse effect on profit?

- sales variance £300W
- wages variance £110W

From this little information, it is not possible to tell. When sales drop by £300 savings are made on the cost of sales and so the profit effect is less than £300. In fact the effect of a sales variance is equivalent to the gross profit which should have been made by those sales:

Profit effect of sales variance = sales variance x budget gross profit percentage

If the previous example referred to £300 of tobacco sales, with a gross profit percentage of 12%, then the profit effect of the sales variance would be £300W x 12% = £36W.

However, if the example had referred to £300 of meeting room sales, the profit effect would have been considerable as there is almost no cost of sales in this instance.

Calculate the profit effect of:

Sales variance	*Budget gross profit*	*Profit effect*
500B	*68%*	
1100W	*13%*	
70B	*60%*	

Sales variance	Profit effect
500B	340B
1100W	143W
70B	42B

A restaurant operating statement shows the actual food gross profit was £6410 and the budget gross profit was £6350. There are two factors which can contribute to this variance of £60B:

- the net food sales variance was £350B, with an effect on profit of £350B x 66.8% = £234B
- the actual gross profit percentage was worse than the budget.

The budget gross profit percentage is 66.8% and the actual gross profit percentage is 65.1%, and the variance is 1.7%W. To calculate the effect on profit:

Profit effect of gross profit percentage variance = actual sales x gross profit percentage variance
= 9850 x 1.7%W
= £167W

To summarise, the gross profit variance can be split into two components:

- profit effect of sales variance = £234B
- profit effect of gross profit percentage variance = £167W
- total gross profit variance = £60B

Note that the figures in the above example do not quite add up (234B and 167W is equivalent to 67B not 60B) because of the approximation of gross profit percentages. This is called a *rounding error*. £5 to £10 is not worth worrying about in the interpretation of departmental operating statements.

It is now possible to identify where management attention should be focussed — clearly there is a major problem with gross profit rates (not immediately apparent from the departmental operating statement).

Complete the table below.

	Example 1	Example 2	Example 3	Example 4
Actual sales	*5000*	*5000*	*3000*	*5500*
Budget sales	*4000*	*4000*	*3200*	*5300*
Sales variance	*1000B*			
Actual GP%	*67%*	*71%*	*53%*	*53%*
Budget GP%	*69%*	*68%*	*48%*	*55%*
GP% variance	*2%W*			
Profit effect sales variance				
Profit effect GP% variance				
Total gross profit variance	*590B*			

	Example 1	Example 2	Example 3	Example 4
Actual sales	5000	5000	3000	5500
Budget sales	4000	4000	3200	5300
Sales variance	1000B	1000B	200W	200B
Actual GP%	67%	71%	53%	53%
Budget GP%	69%	68%	48%	55%
GP% variance	2%W	3%B	5%B	2%W
Profit effect sales variance	690B	680B	96W	110B
Profit effect GP% variance	100W	150B	150B	110W
Total gross profit variance	590B	830B	54B	—

A steadily worsening situation needs corrective action to avoid a major crisis in the future. One of the best ways to monitor trends is to keep a period by period summary of variances extracted from a departmental operating statement:

	Period 1	Period 2	Period 3
Profit effect of sales variance	118B	106W	83B
Profit effect of GP% variance	95W	120W	149W
Wages variance	89W	18B	21W

When financial performance is highlighted in this way it is easy to spot worsening trends.

SECTION 3
Using budgets for planning and control

After completing this section you will be able to:

- understand how revenue budgets should be prepared
- prepare a simple profit forecast for an operating department using given historic data and specified assumptions
- prepare a simple revenue budget for an operating department using a given profit forecast and given quantified actions for profit improvement
- understand how revenue budgets are used to control business performance.

INTERPRETING FINANCIAL RESULTS

Objectives are decided by top management, but it is managers at every level who have the responsibility of trying to meet those aims. It is therefore essential that targets are seen to be fair and attainable, and so managers need to have sufficient power and authority within the organisation to meet whatever responsibilities they have. Defining these responsibilities clearly is an important part of successful budgetary control.

Imagine that you are the manager of the rooms department at the Crown Hotel. In August the hotel manager tells you that she requires a departmental operating profit (DOP) of £370,000 from the rooms department in the next financial year 1 January to 31 December. Note below how you would plan to achieve that DOP.

36

There are four steps in the preparation of revenue budgets:

- *forecasting* what profit will be made if the business continues as it is at present, with the same levels of expenses and the same trends in volume and average spend
- *identifying the gap* between the forecast profit and the profit objective
- *planning action* to be taken to close the gap
- *recording the plan* in such a way that it can be easily monitored.

FORECASTING

Some forecasting is done by accountants, but often managers will be asked to contribute to, or verify these forecasts. A forecast is a prediction of some future event, not to be confused with a budget which refers to planned events. Budget preparation starts with a long-term forecast. It is quite difficult to make accurate long-term forecasts.

Prepare a forecast below of how much your monthly take home pay will be in one month's time and in one year's time.

List below the factors which might affect the accuracy of your long-term forecast.

37

Long-term forecasting on levels of pay is more difficult because of the influence of factors which are not entirely within your control, such as:

- the possibility of changing jobs
- promotions or salary increases
- possible changes in taxation rates
- changes in national insurance contributions
- overtime and other premium payments.

Some people believe, quite wrongly, that just because a forecast is not 100% accurate it is valueless. Think back to your own forecast of take home pay. Would you be able to control your finances better with a slightly inaccurate forecast or none at all? The point is that any attempt to plan the future is better than none.

There are three practical things you can do to improve the accuracy of your long-term forecasts:

- Maintain a detailed analysis of past achievements.
- Keep up-to-date with any external influences likely to affect your business, such as changes in the market or competition.
- Learn some simple statistical techniques.

The steps in long-term forecasting are to:

- Prepare a long-term volume forecast (number of room nights or number of covers for example).
- Project the average spend.
- Calculate total sales.
- Calculate expenses, recognising the difference between fixed and variable costs.
- Calculate the departmental operating profit.

The rooms department manager of the Crown Hotel is preparing a profit forecast for 1991, as the basis for the revenue budget. The available data for 1989 and 1990 have been summarised. The number of room nights for each quarter is:

	Quarters			
	1	2	3	4
1989	2937	3756	2276	2684
1990	3130	3868	2347	

In the first quarter of 1990 additional volume was generated by a new engineering firm moving to the town. The firm paid for many of its employees to stay in the Crown Hotel while looking for a home. This stopped after the first quarter, but the firm has continued to be a significant user of the hotel.

Write below your forecast for volume in the final quarter of 1990, and in each quarter of 1991.

First calculate the percentage increase in volume of 1990 over 1989 for each quarter:

	Quarters			
	1	2	3	4
1989/90	+6.6%	+3%	+3%	

On this basis you would assume that the first quarter was exceptional, but there is an underlying volume increase of 3% over 1989. There is no reason why this should change, so you would calculate the 1991 forecast on the basis of 1989 volume plus 3%.

	Quarters			
	1	2	3	4
1989	2937	3756	2276	2684
1990	3130	3868	2347	*2765*
1991	*3025*	*3870*	*2345*	*2765*

The forecasts are rounded to the nearest 5, because this is accurate enough. Some businesses may round to the nearest 10 or 100.

In preparing forecasts for more complex businesses, such as a hotel with several operating departments, it is important to recognise that the level of volume in one department will frequently affect the level of volume in another. For example the number of room nights sold will affect the restaurant sales. This is known as *derived demand*.

The next stage is to forecast the average room rate.

In housekeeping the hours appear to vary in a semi-fixed relationship to volume. *High-low activity analysis* was used to establish that the function was 2300 hours plus 0.198 hours per room night and the forecast calculated accordingly. In the front office the hours appear to be fixed at 2600 per quarter.

For both housekeeping and the front office the mid-1990 wage increase appears to result in an average hourly rate which is 5.6% higher than in the previous year, and this increase has been used to give the forecast rate for the last quarter of 1990 and the first and second quarters of 1991. For the remaining quarters of 1991 rates have been assumed to be 7% higher than in the previous year.

Forecast	**90/4**	**91/1**	**91/2**	**91/3**	**91/4**
Number of room nights	2765	3025	3870	2345	2765
Housekeeping					
productive hours	2845	2900	3065	2765	2845
average hourly rate	2.99	2.99	3.01	3.22	3.20
Front office					
productive hours	2600	2600	2600	2600	2600
average hourly rate	3.54	3.65	3.67	3.86	3.79

Forecasts for other costs are prepared using similar principles:

- identify the fixed and variable elements of the cost
- project the cost according to the volume forecast
- allow for any increases due to inflation.

In the examples so far inflation has been assumed to occur at one time during the year (for instance at a wage review). Some costs, like food costs, may be subject to inflation over the whole year. If inflation is forecast to increase food costs by 6.5% in a year, this is more or less equivalent to 0.5% for a 4-week period. This will increase the *potential food cost percentage* by a factor of 1.005 in each period.

Period	Potential food cost percentage
1	36%
2	36.2% (36 x 1.005)
3	36.4% (36.2 x 1.005)
4	36.6% (36.4 x 1.005)

The potential food cost percentage is forecast to be 39% in period 1 of 1991. Food costs are expected to inflate by 1% in each of the 13 periods. Calculate below the potential food cost percentage for each of the periods:

Now assume that Bowlers' selling prices are increased by 12% in period 7. Recalculate below the potential food cost percentage for periods 7 to 13:

The effect of inflation is to increase the potential food cost percentage as follows:

Period	P1	P2	P3	P4	P5	P6	P7	P8	P9	P10	P11	P12	P13
%	39.0	39.4	39.8	40.2	40.6	41.0	41.4	41.8	42.2	42.6	43.1	43.5	43.9

Without any increase in selling prices, for every £100 of net sales revenue in period 7 the food cost will be £41.40. If the selling prices are increased by 12%, then for £112 of net sales revenue the food cost is the same. This means that after the selling price increase the potential food cost percentage should be 37% (41.4÷1.12).

The adjusted percentages would be:

Period	P7	P8	P9	P10	P11	P12	P13
%	37.0	37.3	37.7	38.0	38.5	38.8	39.2

Some cost forecasts are produced using units for example hours, and unit costs, such as rate per hour. Other costs are expressed as a percentage of sales for example food costs. When this is done adjustments must be made for inflation.

Fixed costs need a different treatment from variable costs. They are sometimes called *policy costs* because they are the result of implementing major policy decisions. Businesses with a high proportion of fixed costs need to review these policy decisions periodically to ensure that these costs do not get out of hand. One technique for doing this is called *zero-base budgeting*. This requires managers to start budget preparation from a zero cost position and to justify all policies by ensuring that the benefits derived exceed the costs incurred.

Now you can put together elements of your forecast for the rooms department of the Crown Hotel. Fill in the data from your previous answers to complete the following table.

(A total figure for forecasted other expenses had been inserted. In reality each of these expenses, for example printing and stationery, and guest supplies, would be forecast separately. Also forecasts are normally based on 4-week periods, rather than the quarters used here for the sake of simplicity.)

	Quarters				
Forecast 1991	**1**	**2**	**3**	**4**	**Total**
Number of room nights					
Average room rate					
Net sales revenue					
Housekeeping					
productive hours					
average hourly rate					
Total					
Front office					
productive hours					
average hourly rate					
Total					
Total wages and staff costs					
Rooms net margin					
Total other expenses	7025	7340	7410	7450	29225
Rooms operating profit					

Forecast 1991	Quarters 1	2	3	4	Total
Number of room nights	3025	3870	2345	2765	
Average room rate	30.03	29.47	31.07	31.22	
Net sales revenue	90,840	114,050	72,860	86,325	364,075
Housekeeping					
productive hours	2900	3065	2765	2845	
average hourly rate	2.99	3.01	3.22	3.20	
Total	8670	9225	8905	9105	
Front office					
productive hours	2600	2600	2600	2600	
average hourly rate	3.65	3.67	3.86	3.79	
Total	9490	9540	10,035	9855	
Total wages and staff costs	18,160	18,765	18,940	18,960	74,825
Rooms net margin	72,680	95,285	53,920	67,365	289,250
Total other expenses	7,025	7,340	7,410	7,450	29,225
Rooms operating profit	65,655	87,945	46,510	59,915	260,025

So the rooms department of the Crown Hotel is forecast to produce a rooms operating profit of £260,025 assuming a continuation of the present operating policies.

IDENTIFYING THE PROFIT GAP AND PLANNING ACTION

Say the financial objective for the Crown Hotel is to produce pre-tax profits of £80,000 in the year 1 January to 31 December 1991. This will enable the company to:

- pay a dividend of 11.8p on each ordinary share
- retain profits of £15,000.

The hotel manager might break these objectives down as follows:

- a rooms department operating profit of £270,000
- a food and beverage operating profit of £40,000
- hotel overheads of £230,000

The rooms department manager has been set an objective of £270,000 departmental operating profit but the forecast suggests that only £260,025 will be achieved. Suggest below general ways in which the profit gap of £9975 could be filled.

Profit can be improved and the gap closed by:

- *increasing volume* by advertising and promotion, by extending opening hours or enlarging capacity, by pricing more competitively
- *increasing selling price*
- *increasing average spend* by personal selling techniques or more effective merchandising
- *reducing cost of sales* by changing menu items or portion sizes, or by substituting one item for another
- *reducing wages costs* by improving productivity, or by finding ways of turning fixed costs into variable costs
- *reducing other operating expenses* by using cost reduction or cost control techiques.

It is always best to try and generate as many ideas for profit improvement as possible, then quantify their effect, and select the ones which are most likely to work.

Imagine that the rooms department manager selects two ideas which he believes will give the desired profit improvement over the year:

	£
• introduce a new front office computer	
cost saving (40 manhours per week)	7785
additional costs: stationery	600
computer hire	1500
net profit improvement	5685
• sell new weekend break package	
additional revenue	6240
additional costs: direct mail	520
laundry (£1.46 x 8 x 39)	455
wages	none
net profit improvement	5265

The first of these ideas relies on having a new front office computer which reduces the wage bill. The second idea outlays money in the first quarter on promoting a special weekend break which will result in an average of eight sales per week for the last 39 weeks of the year at an average room rate of £20. Laundry costs are increased but no additional wages are necessary. Together these two ideas will close the profit gap by £10,950.

RECORDING THE PLAN

There are two parts to recording budgetary plans, both necessary if the budget is to become an effective control mechanism.

The quantified budget This shows how the profit target will be met, incorporating the effects of profit improvement measures.

The written commentary This records the assumptions which went into the forecast and what actions will be taken to achieve the budget objective.

Study the rooms department budget for the Crown Hotel, now amended to incorporate the effects of profit improvement measures. Compare this with the forecast and draft a short commentary below to accompany the budget.

	Quarters				
Budget 1991	**1**	**2**	**3**	**4**	**Total**
Number of room nights	3025	3974	2449	2869	
Average room rate	30.03	29.22	30.60	30.81	
Net sales revenue	90,840	116,130	74,940	88,405	370,315
Housekeeping					
productive hours	2900	3065	2765	2845	
average hourly rate	2.99	3.01	3.22	3.20	
Total	8670	9225	8905	9105	
Front office					
productive hours	2080	2080	2080	2080	
average hourly rate	3.65	3.67	3.86	3.79	
Total	7592	7634	8029	7883	
Total wages and staff costs	16,262	16,859	16,934	16,988	67,043
Rooms net margin	74,578	99,271	58,006	71,417	303,272
Total other expenses	8,070	8,015	8,085	8,125	32,295
Rooms operating profit	66,508	91,256	49,921	63,292	270,977

CROWN HOTEL: ROOMS DEPARTMENT
1991 BUDGET COMMENTARY

Volume It is recognised that 1990 was an exceptional year because of the additional business generated by the relocation of Jackson's Engineering. The underlying trend is a 3% increase over the base year of 1989, and this has formed the foundation for the 1991 revenue budget. An additional eight room nights per week have been attributed to the new weekend break promotion in quarters 2, 3 and 4.

Average room rate It is expected that the historic pattern of seasonal rate fluctuations will continue. Allowance has been made for a 4% increase in selling prices from the beginning of the third quarter. Average rates have been slightly depressed in quarters 2, 3 and 4 by the weekend break with a rate of £20.

Wages and staff costs In the main historic levels of productivity will be achieved or bettered. A new front office computer system will result in a saving of 40 manhours per week. Small improvements of housekeeping productivity will be achieved as a result of the weekend break. It is anticipated that average rates will increase by 7% as a result of the annual wage review, taking effect from the third quarter onwards.

Other expenses In general usage rates and unit costs have not undergone any significant change. However extraordinary costs of direct mail (£520) for the weekend break have been incorporated in the first quarter. Additional costs of stationery (£600) and equipment hire (£1500) have also been included because of the new front office system.

BUDGETS AS CONTROLS

Budgets are used to plan and control business.

Think back to Sections 1 and 2, and describe briefly below how budgets are used to control profit performance.

INTERPRETING FINANCIAL RESULTS

Operating statements are used for monitoring performance against budget. They are usually prepared every four weeks and contain:

- budgets for the period
- actual results (actuals) for the period
- variances for the period
- budgets for the year to date
- actuals for the year to date
- variances for the year to date.

Variances may be shown in two ways — the monetary variance and the percentage variance. Variances are annotated as B (Better) or W (Worse). Sales variances can be analysed to identify the profit effect of volume and GP% variances.

Most businesses report revenue information on a more frequent basis than every four weeks. Often sales are compared with budget on a weekly or even daily basis.

In each budget period the actual results are measured, compared against the budget and any variances highlighted. A written commentary on the variances and corrective action taken should be prepared every period. This should also describe how successfully planned actions included in the budget have been achieved and will be useful for any discussions with senior management/directors.

A manager has to work closely with others to achieve effective budgetary control, so it is important that you keep your staff well informed of progress against budget and involve them fully in any corrective action.

Remember the most important step is to take the necessary action to put the business back on course to achieve the profit objective.

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